77-1724
No. 78-

IN THE

Supreme Court of the United States

October Term, 1977

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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June 2, 1978

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Citations

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Petitioners, Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey C. Hopkins,* S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips, Jeptha H. Wade, Anchor Corporation and Fundamental Investors, Inc., respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on January 11, 1978.

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* Deceased.

Opinions Below

The opinions of the District Court (Hon. Henry F. Werker) are reported at 404 F. Supp. 1172 (S.D.N.Y. 1975) and at 426 F. Supp. 855 (S.D.N.Y. 1977). The District Court also filed an unreported opinion and order denying a motion for reargument on January 7, 1976. The opinion of the Court of Appeals is reported at 567 F.2d 1208 (2d Cir. 1978). All four opinions below are reproduced in the appendix to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on January 11, 1978, and a timely petition for rehearing was denied on March 9, 1978. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Question Presented

Plaintiffs*, two out of 90,000 shareholders of a mutual fund, seek to maintain a derivative action, purportedly on behalf of the fund, against the investment adviser and various directors of the fund for an investment loss sustained by the fund. The disinterested directors of the fund, who are not defendants in the lawsuit, exercising their business judgment and acting with the advice of independent special counsel, concluded that maintenance of the derivative action was contrary to the best interests of the fund and its shareholders, and instructed the fund's litigation counsel to move to dismiss the derivative action.

The District Court held, in its first opinion, that the disinterested directors had the power, as a matter of business judgment, to determine on behalf of the fund, not to prosecute the possible claim. After permitting extensive discovery on the issue of the independence of the disinterested directors, the District Court held, in its second opinion, that the disinterested directors were truly independent and had acted in good faith in making this determination. Accordingly, the District Court granted the motion to dismiss. The Court of Appeals, while agreeing that the disinterested directors had acted in good faith, held that the Investment Company Act of 1940 impliedly precluded the disinterested directors from exercising their business judgment to forego prosecution of the possible claim against the investment adviser and the other directors. On this basis, the Court of Appeals reversed and remanded the case.

Question: Are the independent and statutorily disinterested directors of a mutual fund incapacitated, *as a matter of law*, from exercising their business judgment to determine whether the maintenance of a stockholder's derivative action against the investment adviser and various directors of the fund for an investment loss is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholder's derivative action be permitted to proceed, in any and all events, even though the independent and statutorily disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

* In this petition respondents are referred to as "plaintiffs" and petitioners as "defendants."

Statutes Involved

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b), (1970) and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b) (1974).

Statement of the Case

This case arises out of the purchase in 1969 by Fundamental Investors, Inc. ("Fundamental"), a mutual fund,

of $20 million of the commercial paper of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., a leading commercial paper dealer. At the time of the purchase, Penn Central commercial paper was rated "prime" (the highest rating) by the National Credit Office, a subsidiary of Dun & Bradstreet, Inc., the most widely utilized commercial paper rating agency in the country. Fundamental had a portfolio composed largely of equity securities and worth approximately $1 billion. The Penn Central commercial paper was purchased by Fundamental as a short-term investment of unemployed cash, i.e., a temporary utilization of funds until they were needed for purchases of equity securities in the stock market. Commercial paper of major national corporations has traditionally been considered by the financial community to be a cash equivalent.

On June 21, 1970, Penn Central, the sixth largest corporation in the country, filed a Petition for Reorganization, and the notes purchased by Fundamental (and many other financial institutions, universities, charitable organizations, etc.) were not paid at maturity.

On November 4, 1970, Fundamental initiated an action, with three other plaintiffs, against Goldman, Sachs & Co. ("the *Welch* action") under the federal securities laws for rescission of their purchases of the notes. The Complaint charged that Goldman, Sachs & Co., the exclusive dealer in Penn Central commercial paper, had withheld material, adverse non-public information on the financial condition of Penn Central.

On February 5, 1973, more than three years after the purchase by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the *Lasker* action") purportedly on behalf of Fundamental. The Complaint charged Anchor Corporation (the investment adviser to Fundamental) and all of the directors of Funda-

mental at the time of the purchase (i.e. 1969), with violations of statutory and common law duties in making and retaining the investment for Fundamental in Penn Central commercial paper.

On July 30, 1973, on motion of all defendants, and prior to joinder of issue, then District Judge Murray I. Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental against Goldman, Sachs & Co. in the *Welch* action.

On July 9, 1974, Fundamental settled the *Welch* action as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5.25 million in cash and assigned to Fundamental a 73.75 per cent interest in the proceeds of the $20 million of notes in the Penn Central reorganization proceedings.

On July 24, 1974, at their next regular meeting, the Board of Directors of Fundamental reviewed the status of the *Lasker* action, and determined that the five directors who (a) were not affiliated in any way with the investment adviser (Anchor), and (b) were not directors at the time of the events complained of in the *Lasker* action, and (c) were not defendants in the *Lasker* action, would, acting as a quorum pursuant to the by-laws and Delaware law, constitute the Board of Directors to decide what position Fundamental should take regarding the *Lasker* action.* The

* Plaintiffs argued below that the five disinterested directors could not be independent because they had been nominated for their positions on the Board by defendants in the *Lasker* action. The District Court, after reviewing the extensive discovery on the issue of independence, held that there was no evidence whatsoever that any of the five disinterested directors was influenced in any way by any defendant in the *Lasker* action. See 426 F.Supp. at 846. The testimony clearly shows that no defendant ever mentioned the *Lasker* action to any one of the five directors prior to, at the time of, or in connection with, his or her nomination to the Board. Indeed, the first time that any of the five disinterested directors focused, at all, on the *Lasker* action was at the July 24, 1974 meeting when they were designated a quorum to decide what position should be taken by Fundamental—this meeting occurred several years after most of them became directors. Each of the five disinterested directors was a person of high repute and achievement in business or government, and each was selected by the Directors Qualification Committee which, at all times, consisted of a majority of disinterested directors.

six other directors, i.e. the four who were affiliated with Anchor and the two who were not affiliated with Anchor but who were named as defendants in the *Lasker* action, determined to take no part in the decision.

To assist them in their deliberations, the disinterested directors retained independent special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York. Judge Fuld had no previous connection with any of the parties.

On December 5, 1974, after several months of investigation, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum, and advised:

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provisions of statute or of any common law or contractual obligation to the fund, in connection with the acquisition and retention of the Penn Central commercial paper."

Judge Fuld also identified and analyzed the alternative courses of action available to the directors, and concluded his memorandum as follows:

> "It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

After receiving Judge Fuld's December 5, 1974 memorandum, the disinterested directors carefully reviewed it and raised several questions regarding the subjects covered in the memorandum and the alternatives available to them.

In response to these questions raised by the disinterested directors, on December 18, 1974, Judge Fuld delivered a brief supplemental memorandum in which he advised, among other things, that whether or not a corporation seeks to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management, and is left to the discretion of the directors.

On December 18, 1974, the disinterested directors held a special meeting devoted exclusively to this subject. At the meeting they discussed the entire matter with Judge Fuld at length, and questioned management about the details of the underlying transaction. After several hours of discussion, they adjourned the meeting and decided to give the matter further thought before reaching a decision.

On January 6, 1975, having conferred further with Judge Fuld in the interim, the disinterested directors held another special meeting of the Board. After several hours of review and deliberation, they voted unanimously to instruct the fund's litigation counsel to move to dismiss the *Lasker* action as contrary to the best interests of Fundamental. Their reasoning is set forth at length in the record and is quoted in the first opinion of the District Court.* (404 F. Supp. at 1176-77).

The District Court, in its first opinion, endorsed the basic theory of the motion to dismiss (i.e. that the disinterested directors had the power, in the exercise of their business judgment, to determine that the corporate claim asserted in the derivative action should not be prosecuted), but denied the motion with leave to renew following discovery on the sole issue of the independence of the

* Among the factors considered by the directors were the following: (a) Judge Fuld's opinion that Anchor had not violated any law or contractual obligation, (b) the directors' own determination that Anchor had acted in good faith in recommending the Penn Central investment, (c) the potential business disruption to Fundamental and its investment adviser if the action were to proceed, (d) the fact that numerous other respected institutional investors (including banks, hospitals, universities etc.) had made the same investment at the same time.

disinterested directors. The District Court wrote (404 F. Supp. at 1180):

> "If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board."

At the conclusion of extensive discovery proceedings Fundamental renewed its motion to dismiss. The District Court granted the renewed motion and wrote (426 F. Supp. at 849):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." [emphasis supplied].

On January 11, 1978, in an opinion devoid of supporting legal authority and contrary to all relevant precedents, the Court of Appeals reversed and remanded, concluding that, *as a matter of law,* the Investment Company Act of 1940 impliedly deprived the independent and statutorily disinterested directors of the fund of their power to determine *not* to assert a possible corporate claim against the investment adviser and other fund directors for an investment loss sustained by the fund.

A timely petition for rehearing *in banc* was denied on March 9, 1978.

Reasons for Granting the Writ

The decision of the Court of Appeals—holding that, *as a matter of law,* disinterested directors of a mutual fund, acting in good faith and with the advice of independent counsel, lack the power to exercise their business judgment to terminate a stockholder's derivative action against the investment adviser and various directors of the fund, maintenance of which the disinterested directors have concluded to be contrary to the best interests of the fund and its share-

holders—raises an important question involving the extent, if any, to which the Investment Company Act of 1940 displaces settled state law concerning corporate governance. This question has not been, but should be settled by this Court.* The decision of the Court of Appeals for the Second Circuit is in conflict with principles enunciated by this Court, is in conflict with applicable precedent in the Court of Appeals for the First Circuit (as well as its own prior precedents), and raises issues of substantial public importance.

The decision of the Court of Appeals, if allowed to stand, will undermine basic principles of corporate governance in the mutual fund industry.** Under this decision, mutual funds can be held hostage, in compulsory litigation, to the whims of a single stockholder. Such persons will be empowered to compel large public mutual funds, like Fundamental, to assert claims in litigation which disinterested directors, who are the legally elected representa-

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* The importance of the case was expressly recognized by the Court of Appeals in the opening sentence of its opinion:

> "*This appeal* by two mutual fund shareholders *raises an important question of first impression . . .*" [emphasis supplied]. (567 F.2d at 1208).

The importance of the case to the entire mutual fund industry, and to the rational utilization of the federal court system, is indicated by the *amicus* briefs filed in this case by Investors Diversified Services, Inc., the largest mutual fund complex in the country, and by the Investment Company Institute, the national association of mutual funds, investment advisers and underwriters.

** Although the Court of Appeals purported to confine its decision to the mutual fund industry, the central basis for its decision was a legal presumption that the independent directors could not pass fairly on plaintiffs' proposed corporate claims against the investment adviser and their fellow directors. See fn.*, p. 15 below and 567 F.2d at 1212. However, this presumption cannot readily be confined to mutual fund corporations—the pessimistic view of human nature which underlies the presumption applies, if at all, to all directors of all corporations, not just to directors of mutual fund corporations. Thus, if the opinion below is permitted to stand, it may well have a serious impact on corporate governance beyond the mutual fund industry.

tives of *all* stockholders, have determined to be contrary to the best interests of those mutual funds and their many shareholders.

The potentially harmful effects of the decision on mutual funds, their investment advisers and the federal courts are manifest. Invariably, some investments made by mutual funds will result in losses and others in profits. If the investment adviser and directors of mutual funds can be called to account in stockholder's derivative actions on every investment that results in a loss, without the disinterested directors being able to deflect such suits, where appropriate, in the exercise of their good faith business judgment, there would be unlimited potential for litigation which could cripple the mutual fund industry. Every investment decision (i.e. to buy, sell or hold) would become a potential subject for time consuming and expensive litigation in the federal courts; management of mutual funds would become an impossibly hazardous business, and the federal courts would be thrust into the role of arbiters of the propriety of every unsuccessful investment decision. Thus, the effects of the decision below are extraordinarily severe, since each fund makes literally thousands of investment decisions each year.

In short, this case raises the fundamental question of whether the legally elected representatives of *all* stockholders, or a single stockholder, who may well not have the broader interests of all stockholders in mind, will have the right to determine whether or not the mutual fund should assert a possible claim in litigation.

I.

The decision of the Court of Appeals in this case is in conflict with principles enunciated by this Court.

In a line of cases going back 75 years, this Court has held that the decision whether or not to prosecute litigation on behalf of a corporation rests solely with the board of directors. Absent fraud, corruption, or similar invalidating factors, the board's exercise of business judgment is final and a stockholder's derivative action does not lie. See, *e.g.*, *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917).

In *Corbus, supra*, this Court set forth the business judgment rule in the context of a litigation decision as follows:

> "The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation

> to an act which their judgment does not approve, or to substitute his judgment for theirs." 187 U.S. at 463.

This doctrine was subsequently reaffirmed by this Court in *United Copper, supra.* In that case, the plaintiff stockholder claimed that his corporation had been damaged by the defendants' actions in violation of the antitrust laws. The board considered suing the defendants and refused to do so. This Court ruled that the stockholder could not then maintain a derivative action on behalf of the corporation. Justice Brandeis wrote:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. 244 U.S. at 263.

The Court of Appeals in the case at bar legislated an exception to the business judgment rule inconsistent with the cases cited above and inconsistent with the structure of the Investment Company Act of 1940—the statute relied on by the Court of Appeals. If there is to be an exception to this rule, for mutual funds, that exception should be legislated by Congress and not by the courts. Neither the provisions of the Investment Company Act of 1940 nor the legislative history suggests that Congress ever intended any such exception.*

* Indeed, the legislative history, which was not cited by the Court of Appeals, contradicts the result reached by the Court of Appeals in this case. See Point IV below.

II.

The decision of the Court of Appeals in this case is in conflict with applicable and controlling state law of corporate governance and the pronouncements of this Court on the deference to be given state law in such matters.

This Court has specifically held that in the absence of any *express* federal statutory provision to the contrary, state law governs the powers of directors. Thus, in *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 479 (1977), this Court last year wrote:

> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." [quoting from *Cort* v. *Ash,* 422 U.S. 78, 84 (1975)] [emphasis in original].

Fundamental, the mutual fund involved in this case, is a Delaware corporation.* Delaware General Corporation Law, Section 141(a), empowers the board of directors of a corporation to manage the affairs of the corporation. No distinction is made under that law for mutual fund corporations. Management of the affairs of a corporation has long been held to include the power to decide whether or not to pursue a possible claim of the corporation in litigation. The District Court so held at bar, and the Court of Appeals did not take issue with this principle.

The Court of Appeals, however, erroneously differentiated between mutual fund directors and directors of

* Congress, when it enacted the Investment Company Act of 1940, left the organization of mutual funds to state law. Mutual funds are creatures of state law, not (like national banks, for example) creatures of federal law.

other types of business corporations with respect to their business judgment power to maintain or not maintain litigation on behalf of the corporation.* In so doing, the Court of Appeals engrafted onto the Investment Company Act of 1940 new limitations on the powers of mutual fund directors *not* placed there by Congress and in conflict with the plan of corporate governance intended by the law of Delaware.

The Court of Appeals did not and could not cite any provision of federal law which *expressly* overrides or abrogates the power of the directors under state law. The fact is that there is no such provision in the Investment Company Act of 1940 or in any other federal statute. Thus, the decision of the Court of Appeals is in conflict with the principles clearly enunciated by this Court in *Santa Fe* and *Cort, supra.* The Court of Appeals simply created a rule of federal law where none exists. In this case, the Delaware law must be given effect since there is no federal law *expressly* (or, as shown in Point IV, impliedly) overriding Delaware law.

III.

The decision of the Court of Appeals for the Second Circuit in this case is in conflict with the decision of the Court of Appeals for the First Circuit in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973).

The Court of Appeals in this case singled out mutual fund directors and, without warrant, distinguished them

* The Court of Appeals also erroneously stressed the fact that the decision at bar was reached by a "minority" of the board, disregarding the fact that the "minority" of five disinterested directors indisputably constituted a lawful quorum under Delaware General Corporation Law Section 141(b) and under Fundamental's certificate of incorporation.

from directors of all other types of corporations. Thus, the Court of Appeals wrote (567 F.2d at 1212 n.14):

> "We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of a similar power by directors of other types of corporations."*

The notion that mutual fund directors—especially the disinterested directors—are under a special disability vis-a-vis directors of other types of corporations in exercising business judgment concerning the maintenance of litigation, has been firmly rejected by the Court of Appeals for the First Circuit in the leading case of *In re Kauffman Mutual Fund Actions,* 479 F. 2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), a case not even cited by the Court of Appeals below.** The Court of Appeals for the First Circuit there wrote (479 F.2d at 266-267):

> ". . . the underlying business judgment may be sufficiently unsound to call for correction. But it does not follow that it is to be conclusively presumed in such a case that an unaffiliated, or disinterested director, if demand were made upon him, would be

* As noted above at p. 9, this attempt by the Court of Appeals to limit the scope of its ruling is illusory. The central basis for the decision of the Court of Appeals was the legal presumption that, because the independent directors had to work and interact with their fellow directors, "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." 567 F.2d at 1212. How the "unique nature" of the mutual fund industry supports application of such a presumption is not explained, nor can it be. In any event, application of such a presumption in the context of mutual funds conflicts with settled law in another circuit, as shown in Point III.

** The result reached by the Court of Appeals at bar also renders meaningless Rule 23.1 Fed. R. Civ. P. Why have a rule requiring demand on directors if the directors have no power to act?

unable to exercise an independent judgment in considering what new course to take." [footnote and citation omitted].

"Nor do we think that an exception is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. Normally self-dealing by any corporate directors is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. *In order to make sure that the directorate not be top-heavy, it* [*Congress*] *provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from a disinterested director in any other corporate venture.* All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' [citation omitted]. When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim, [citation omitted], *it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure'* [i.e., the disinterested directors] *to decide on the appropriate corporate response.* [citation omitted]. *To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it.*" [emphasis supplied].

At bar, under the *per se* rule of disqualification adopted by the Court of Appeals, the disinterested directors were improperly deprived of their opportunity to serve as "watchdogs" of the fund's best interests because they were presumed to be legally incapable of deciding on the appropriate corporate response.

IV.

The reasoning of the Court of Appeals, insofar as it purports to find a basis for its holding in the Investment Company Act of 1940, does not withstand analysis.*

This action is brought under Section 36(a) of the Investment Company Act of 1940. The Court of Appeals

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* The decision below also conflicts with two earlier decisions by the Court of Appeals for the Second Circuit under the Investment Company Act of 1940: *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 and *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977). In *Fogel supra*, Judge Friendly wrote (553 F.2d at 749-50):

> "Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation or recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.
>
> "If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case."

erroneously equated Section 36(a) of the Investment Company Act of 1940 with Section 36(b).* The Court of Appeals reasoned that since Congress, in the 1970 amendments to the Investment Company Act of 1940, "specifically provided in Section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser," it "would surely be anomalous" not to imply the same power for the alleged violations of Section 36(a) of the Investment Company Act of 1940 sued upon here. (567 F.2d at 1212). Why it "would surely be anomalous" is not explained, nor is any authority offered for the proposition.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940 —it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees, irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.

If Congress had intended to provide in Section 36(a), a far broader section than Section 36(b), the unique mechanisms of Section 36(b), it could and would have done so in the 1970 amendments—it did not do so. The Court of Appeals improperly added such a provision to Section 36(a) where Congress saw fit not to do so.

The legislative history, which was not cited by the Court of Appeals, supports defendants' view. Thus, Senate Report No. 91-184, which accompanied the 1970 amendments, states:

> "Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), *the fact that subsection (b) specifically*

* Section 36(a) deals with breaches of fiduciary duty; Section 36(b) deals solely with compensation of investment advisers.

> *provides for a private right of action should not be read by implication to affect subsection (a).*" [emphasis supplied]. 3 U.S. Code Cong. & Ad News, 91st Congress, at p. 4911 (1970).

The foregoing passage, although focusing on the existence of a private right of action, a subject not at issue in this case, indicates that Congress did not intend that the new Section 36(b) be read to affect, in any way, Section 36(a), i.e., old Section 36. In short, the subject of investment adviser compensation, covered by Section 36(b), is *sui generis*.

Moreover, the Report expressly reaffirmed Congress' intent not to disturb the authority of disinterested directors to manage the affairs of a mutual fund in the exercise of their business judgment, consistent with settled state law concerning corporate governance:

> "These provisions highlight the fact that *the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of the directors.* Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. *The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.*" [Emphasis supplied] *Id.*, at p. 4903.

A fortiori, if Congress in Section 36(b), which contains an express right of action, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary, it necessarily follows that Congress, in Section 36(a), where there is no such express right, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary.

At bar, the District Court correctly analyzed and rejected the plaintiffs' argument based on the public policy of the Investment Company Act of 1940 and held (404 F.Supp. at 1179-80):

> "This Court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. [Citations omitted]. It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

On a motion by plaintiffs for reargument, the District Court specifically addressed and rejected the Section 36(b) argument, and held, in an unreported opinion and order (see appendix):

> "That section [36(b)] specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under section 36(a) . . . where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim."

The District Court correctly perceived the distinction between Sections 36(a) and 36(b); the Court of Appeals either misperceived or ignored the distinction.

* * *

In sum, in this case the disinterested directors of the mutual fund, after the fund had received a substantial settlement of its investment loss, and based on the advice of eminent, independent counsel, made a good faith determination, in the exercise of their business judgment, that maintenance of this derivative action was contrary to the best interests of the fund and its shareholders. In so doing the directors exercised managerial power granted under state law. The Court of Appeals concluded that such state law power could not be exercised because of a supposed congressional intent. However, that intent is nowhere expressed in the Investment Company Act of 1940 and is in fact negated by the legislative history of the Investment Company Act of 1940.

The decision below does violence to prior decisions of this Court and conflicts with a decision in another circuit. It presents an important question of federal law which should be decided by this Court concerning the construction of the Investment Company Act of 1940 and the deference to be given by federal courts to state law powers concerning corporate management.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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June 2, 1978

APPENDIX

Opinion of the District Court, September 24, 1975

States v. Bettenhausen, 499 F.2d 1223 (CA10 1974). As stated in *United States v. Fancutt*, 491 F.2d 312, 314 (CA 10 1954):

> "Jury verdicts in criminal cases are to be rendered on the facts as disclosed by evidence and the law as pronounced by the court. That which the prosecutor thinks, believes or knows are not to be given consideration. Such argument is improper."

The issue in this type of proceeding, however, is not whether the actions of the district attorney were error but whether the conviction of the petitioner was the result of an unfair trial in violation of the Fourteenth Amendment. *Sampsell v. People of the State of California*, 191 F.2d 721 (CA9 1951). It is only where criminal trials in state courts are conducted in such a manner as amounts to a disregard of that fundamental fairness essential to the very concept of justice that due process is offended and federal court interference is warranted. *Chavez v. Dickson*, 280 F.2d 727 (CA9 1960). After careful consideration of the record, it cannot be said that the efforts of the prosecutor resulted in a denial of the fundamental fairness essential to the concept of justice. As pointed out in *United States v. Fay*, 350 F.2d 400, 401 (CA2 1965):

> "[For] whatever error the state court may have committed in failing to grant a new trial, the defect in the trial did not attain constitutional proportions. The prosecutor's conduct did not create a situation so prejudicial to the appellant that he was denied a fair trial within the meaning of the due process clause of the Fourteenth Amendment.
>
> . . . .
>
> "Conduct of state prosecutors which it was contended was unfair and prejudicial has consistently been held on collateral attack in the federal courts to fall short of constituting a lack of due process. [Citations omitted.]"

This is not a case where the comment of the prosecutor infringed upon any specific guarantees of the Bill of Rights. It is not a case where the prosecutor consistently and repeatedly misrepresented the evidence before the jury. Cf. *Miller v. Pate*, 386 U.S. 1, 87 S.Ct. 785, 17 L.Ed.2d 690 (1967). It is not a case where there was non-disclosure by the prosecution of specific evidence favorable to the accused. Cf. *Brady v. Maryland*, 373 U.S. 83, 83 S.Ct. 1194, 10 L.Ed.2d 215 (1963). There was otherwise no unfair manipulation of the evidence so as to have an effect on the jury's determination. The evidence of guilt was strong. In fact, the petitioner admitted guilt but relied upon the defense of entrapment. The actions of the prosecutor constituted only the ordinary trial errors of a prosecutor, not that sort of flagrant misconduct necessary to establish a denial of constitutional due process for relief on collateral attack. See *Donnelly v. De Christoforo*, 416 U.S. 637, 94 S.Ct. 1868, 40 L.Ed.2d 431 (1974).

Accordingly for the foregoing reasons the Petition for Writ of Habeas Corpus will be denied.

It is so ordered.

Howard M. LASKER and Irving Goldberg, Plaintiffs,

v.

Harry G. BURKS, Jr., et al., Defendants.

No. 73 Civ. 552 (HFW.)

United States District Court, S. D. New York.

Sept. 24, 1975.

As Amended Oct. 17, 1975.

Two stockholders of registered investment company brought shareholders' derivative action against company's in-

vestment advisor and several former and present members of the company's board of directors. On the company's motion to dismiss, the District Court, Werker, J., held that an independent minority of the company's board of directors, who constituted a quorum, had the power to decide what position the company should take in the suit; that the strong public policies behind the Investment Company Act and the Investment Advisers Act did not bar the board of directors from exercising its business judgment on the suit; that the board's decision not to sue was not tantamount to an illegal ratification; and that a question of fact existed as to whether the minority directors were truly disinterested and independent.

Motion denied without prejudice.

1. Corporations ⟹310(1)

In stockholders' derivative suit against, inter alia, several company directors, disinterested directors, who were minority of board, constituted quorum, and were designated by full board to make decision as to company's position in the suit, had power to exercise their business judgment as to what position company should take. Fed.Rules Civ. Proc. rule 23.1, 28 U.S.C.A.

2. Corporations ⟹310(1)

Absent fraud or corruption or other factors, stockholders cannot force corporation to sue. Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

3. Corporations ⟹310(1)

Strong public policies behind Investment Company Act and Investment Advisers Act did not deprive corporate board of directors of its power to exercise business judgment over stockholders' derivative action. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.; Investment Advisers Act of 1940, § 201 et seq., 15 U.S.C.A. § 80b-1 et seq.; Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

4. Securities Regulation ⟹218, 223

Causes of action under Investment Company Act and Investment Advisers Act are implied rights of action. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.; Investment Advisers Act of 1940, § 201 et seq., 15 U.S.C.A. § 80b-1 et seq.

5. Corporations ⟹310(1)

Board of directors' decision to oppose stockholders' derivative suit in exercise of its business judgment did not amount to illegal ratification. Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

6. Federal Civil Procedure ⟹1741

In investment company's stockholders' derivative action against company's investment adviser and several former and present members of company's board of directors, question of fact existed as to whether minority directors were truly disinterested or independent, precluding granting motion to dismiss on ground that disinterested minority of board of directors had determined that, in their business judgment, action was contrary to best interests of company shareholders. Fed.Rules Civ.Proc. rules 12(b), 23.1, 28 U.S.C.A.

Aranow, Brodsky, Bohlinger, Benetar & Einhorn, New York City, for plaintiffs.

Dewey, Ballantine, Bushby, Palmer & Wood, New York City, for defendants Burks, Hopkins, Kemmerer, Monroney, Phillips & Wade.

Seward & Kissel, New York City, for defendant Fundamental Investors, Inc.

Pollack & Singer, New York City, for defendants Burr, Chalker, Hutchinson, Haire & Anchor Corp.

MEMORANDUM DECISION AND ORDER

WERKER, District Judge.

This is a shareholders' derivative action brought by two stockholders on behalf of Fundamental Investors, Inc.

("Fundamental" or the "Fund"), a registered investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* The defendants are the Fund's investment adviser, Anchor Corporation ("Anchor"), a registered investment adviser under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, and several former and present members of the Board of Directors of the Fund. The dispute between the parties centers around the Fund's purchase, on Anchor's recommendation, of $20 million in commercial paper of the now bankrupt Penn Central Transportation Company. As described in detail below the complaint charges that in connection with the purchase of the Penn Central paper the defendants violated various sections of the Investment Company Act, the Investment Advisors Act and the common law. The Fund, joined by all defendants, has now moved under Rule 12(b) of the Federal Rules of Civil Procedure to dismiss this action on the ground that the independent members of the Board of Directors of the Fund have unanimously determined that, in their business judgment, this action is contrary to the best interests of the shareholders of the Fund.

BACKGROUND

The Fund made its purchases of Penn Central 270-day notes from Goldman, Sachs & Co., in lots of $5 million each on November 26, December 2, 4 and 8, 1969. Unfortunately for the Fund and other holders of Penn Central commercial paper, Penn Central, on June 21, 1970, filed a petition for reorganization under section 77 of the Bankruptcy Act with the result that the notes were not paid at maturity or at any time to date. Faced with the possibility of a substantial loss, the Fund and other plaintiffs instituted suit in the Southern District of New York on November 4, 1970 against Goldman, Sachs & Co., for rescission of their purchases of the Penn Central Notes. That action was entitled *Welch Foods, Inc. v. Goldman, Sachs & Co.*, D.C., 398 F.Supp. 1393 (the "*Welch*" action).

The instant derivative suit was filed on February 5, 1973. Jurisdiction was predicated on section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and pendent jurisdiction. The complaint alleges that in making the purchases of Penn Central commercial paper the Fund and Anchor relied solely and exclusively on Goldman, Sachs & Co., and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper. By failing to make an independent investigation it is alleged that Anchor failed to meet its responsibility as the Fund's investment adviser and that the Fund's directors knew or should have known of, and acquiesced in, the failure of Anchor to meet its responsibilities and thus failed to meet their responsibilities as members of the Fund's Board of Directors. Had an independent investigation been made it is alleged that a number of material adverse facts concerning the financial condition of the Penn Central and the quality of its commercial paper would have been learned. As a result of their actions, or inactions, the defendants are charged with engaging in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund in violation of section 36 of the Investment Company Act. Anchor is also alleged to have violated section 206, the antifraud section of the Investment Advisors Act of 1940. Plaintiffs also claim that the defendants violated their common law fiduciary duty to the Fund and that Anchor, aided and abetted by the directors, breached its investment advisory contract with the Fund.

The complaint goes on to allege that from November 28, 1969 to June 21, 1970, the date Penn Central filed for reorganization, the financial condition of the Penn Central deteriorated. During this period it is alleged that Anchor and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn

Central and the quality and safety of its commercial papers. It is also alleged that during this period the Fund's directors failed in their obligations to make adequate attempts to resell the Penn Central commercial paper it held and that Anchor failed to advise the Fund of the advisability of selling the commercial paper. Plaintiffs again claim that these acts by the defendants violate section 36 of the Investment Company Act; that Anchor violated section 206 of the Investment Advisers Act; that all defendants breached their common law fiduciary duty; and that Anchor, aided and abetted, by the Fund's directors breached its investment advisory contract. Finally, the complaint alleges that the defendants violated section 13(a)(3) of the Investment Company Act by allowing the Fund to hold more than 10% of the securities of any one issuer (Penn Central) in contravention of the Fund's registration statement filed pursuant to section 8(b) of the Investment Company Act.

Subsequent to the filing of this derivative action, all defendants moved to stay this action pending the resolution of the claims of Fundamental in the *Welch* action. The stay was granted by Judge Gurfein on November 12, 1973. Fundamental's claims against Goldman, Sachs & Co., in the *Welch* action were settled on July 9, 1974. The terms of the settlement provided that Goldman, Sachs & Co. would take back the Penn Central notes, pay Fundamental $5,250,000.00 in cash and assign to Fundamental a 73.75% interest in the proceeds of the notes in the reorganization proceedings.

With the settlement of the *Welch* action, Fundamental had to determine what position to take in this suit. It is necessary to set forth in detail the actions taken by the Fund's Board of Directors since it forms the basis of the defendants' motion to dismiss.

Fundamental's Board of Directors met on July 24, 1974 to review the settlement of the *Welch* action and to decide what position to take in this derivative action. Since five of the directors are defendants in this action and one is a director of Anchor, the Board determined that the remaining five directors who they considered disinterested would, acting as a quorum pursuant to the by-laws,[1] decide what position the Fund should take in this action. The five disinterested directors then decided to retain the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the entire Penn Central matter and to report to the Board.

After reviewing the complaint in this derivative action, the proceedings in the *Welch* action, the files of Anchor and the Fund relating to the purchase of Penn Central paper and after interviewing officers and employees of the Fund and analyzing the facts and the law, Judge Fuld sent a memorandum to the disinterested directors on December 5, 1974 in which he stated his opinion that there was "no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial

1. Section 1 of Article Eight of the Certificate of Incorporation of Fundamental provides that:

"The number of directors which shall constitute the whole board of directors shall be such as from time to time shall be fixed by or in the manner provided in the by-laws which shall also provide the number of directors which shall constitute a quorum; provided, that in no case shall a quorum be less than one-third of the total number of directors nor less than two directors."

Section 4 of Article Six of the By-Laws of Fundamental provides that:

"*Quorum*: Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors shall be necessary for the transaction of business."

paper." (Dec. 5, 1974 Memorandum at 2). Judge Fuld went on to discuss in detail each of the claims asserted in this suit. Finally, Judge Fuld defined and discussed three alternative courses of action which the disinterested directors might pursue, *i. e.*, (1) seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action; (2) conclude that the action is sufficiently lacking in merit and move to have the suit dismissed; and (3) take a neutral position and permit the action to proceed for the Fund's benefit under the auspices of the present plaintiffs.

After the disinterested directors reviewed his report and submitted questions to him, Judge Fuld sent a supplemental memorandum to the disinterested directors on December 18, 1974. In his memorandum Judge Fuld discussed in more detail the possibility that the Board should move to dismiss this suit as not being in the best interests of the Fund and the possible scope of judicial review of such a decision.

The disinterested directors then met in a series of special meetings to consider Judge Fuld's memoranda. The directors met with Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, unaffiliated directors of Fundamental; and Eugene Souther, litigation counsel to Fundamental in this action. Questions were posed by the directors to all of these in attendance concerning the merits of the derivative action and the alternatives open to the Fund's Board. The disinterested directors again met in private and decided to give additional consideration to the problem and convey any questions to the designated Chairman of the disinterested directors, Leon T. Kendall.

A second special meeting of the disinterested directors was held on January 6, 1975. Upon review of the alternatives available, the directors present unanimously determined[2] that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek dismissal of the action. The factors considered by the directors in reaching their conclusion are summarized in the Kendall affidavit ¶ 22, and are as follows:

"(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally

2. One director, Mary S. O'Connor, was not present at the meeting. She had previously told Mr. Kendall what her decision was. That vote was reaffirmed by Mrs. O'Conner at a special meeting of the disinterested directors held on January 22, 1975. Even without her presence, four directors would constitute a quorum.

held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analysed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

DISCUSSION

The Fund now argues that the extensive consideration given to the alternatives available to the independent directors culminating in their decision to seek dismissal of this suit was a good faith exercise of business judgment which cannot be upset by the two shareholder plaintiffs who would force Fundamental to maintain this action. The plaintiffs, of course, dispute this position. After emphasizing, the merits of the claims they have asserted and criticizing the conclusions reached by Judge Fuld, plaintiffs make the following arguments in opposition to the defendants' motion to dismiss: (1) because of the broad regulatory legislation embodied in the Investment Company and Investment Advisers Act, the decision whether to prosecute violations of that Act is not a matter of "business judgment" to be decided by directors of a regulated fund; (2) to seek dismissal of the action would be tantamount to an unlawful ratification of defendants' conduct; (3) if a majority of the board's directors are disqualified, the existence of a "disinterested" minority is irrelevant; (4) as a matter of law the minority directors are not "disinterested;" (5) the minority directors gave undue deference to Anchor in making their decisions; and (6) the motion is premature and defective under Rule 23.1. These arguments will now be considered.

At the outset, the obvious should be stated—a shareholder's derivative suit is an action brought on behalf of a corporation in which any recovery runs in favor of the corporation. Ordinarily, it is the corporation which would seek the right to enforce any cause of action it might have. Rule 23.1 of the Federal Rules of Civil Procedure requires that a complaining shareholder demand action from the board of directors before

bringing suit.[3] The purpose of that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank*, 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

No demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are defendants charged with wrongdoing and as such a demand would be futile.[4] While no set formula has been developed for determining what facts must be plead in order to excuse a demand on the Board of Directors—*see generally*, 7A Wright & Miller Federal Practice & Procedure § 1831 (1972)—that issue is not presented in this case. Instead, this case presents the rather unique situation where a designated independent minority of a Board has taken unilateral action with respect to a suit brought on behalf of the corporation. The decision of the independent directors was made after the settlement of the *Welch* action which put an end to the stay in this suit. Plaintiffs argue that even if suit were instituted at the present time (*i. e.*, after settlement of the *Welch* action) no prior demand on the Fund's Board would have been necessary because the majority of directors would be disqualified. To allow a minority of the Board to seek dismissal of the suit would, it is argued, destroy the role of "presumptive disqualification."

While no case is directly in point, this circuit has recently considered an analogous issue in *Brody v. Chemical Bank, supra*. There, the district court had dismissed the derivative causes of action in plaintiff's complaint because the allegations in the complaint were insufficient to excuse a demand on the Board of Directors. Plaintiff had alleged futility of demand because the majority of directors were controlled by the defendant corporation. However, since institution of the suit, a new Board had been installed but no demand was made on it. The Second Circuit agreed that a demand should have been made but remanded because of the gravity of the alleged wrongdoing. 482 F.2d 1111 at 1114 (2 Cir.). After remand, the plaintiffs filed a second amended complaint but made no demand on the Board of Directors because they alleged that a demand on the Board of Directors at the time the action was originally com-

3. Rule 23.1 provides:
"In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

4. No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶ 7(b).

menced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

[1] In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1–252–53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e. g., Hawes v. Oakland,* 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM,* 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Allegheny Corp. v. Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

[2] As the Supreme Court recognized in *United Copper, supra,* the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U.S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca,* Docket #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

[3, 4] This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock,* 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d

bringing suit.[3] The purpose of that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank,* 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 263 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

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4. No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶ 7(b).

menced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

[1] In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1–252–53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e. g., Hawes v. Oakland,* 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM,* 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Alleghany Corp. v. Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

[2] As the Supreme Court recognized in *United Copper, supra,* the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U.S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca,* Docket #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

[3, 4] This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock,* 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d

Cir. 1961); *Bolger v. Laventhol, Krekstein, Horwath & Horwath,* 381 F.Supp. 260 (S.D.N.Y.1974). It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is "implied" the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final.

[5] The court must also reject plaintiffs' argument that the decision not to sue was tantamount to an illegal ratification. Although it can be argued that derivative suits should be allowed when the Board has refused to sue on a nonratifiable wrong—*see* Note, Demand on Directors and Shareholders as a Prerequisite To a Derivative Suit, 73 Harv. L.Rev. 746, 762 (1960); *Rogers v. American Can Co.,* 305 F.2d 297 (3d Cir. 1962), the question of business judgment is separate from the question of ratification. *S. Solomont & Sons Trust v. New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E.2d 241, 247 (1950). Many of the cases which established the business judgment rule and its relation to derivative suits have involved claims which were arguably non-ratifiable. *See, e. g., United Copper, supra; Ash v. IBM, supra* (antitrust violations).

[6] Another question which has been considered is whether the merits of the plaintiffs' claim should be considered in deciding whether the directors decision should be upheld. To do so would place the Court in the position of substituting its judgment for that of the directors which if made in good faith should not be disturbed. The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision.

If the minority directors were truly disinterested and independent the court will not substitute its judgment for that of the Board. Plaintiffs have not argued that the minority directors have acted fraudulently or corruptly. They have argued that they are not disinterested or independent because they occupy similar positions with other funds in the Anchor group and that Anchor controls the selection and nomination of the Fund's directors. This assertion has been denied and it is alleged by the movant that these directors were nominated by a three man Directors Qualification Committee of which two members were unaffiliated with Anchor.

Interest or lack of independence would go toward the issue of good faith. I am constrained therefore to permit the plaintiffs to pursue discovery with respect to the relationships of the minority directors and the Qualifications Committee to determine whether the minority directors were disinterested or independent. It would appear that all of the other questions resolved herein are dependent upon a resolution of this issue. The plaintiffs are to conduct their discovery within 90 days from the date hereof.

The motion is denied without prejudice to renew the same upon the completion of discovery.

So ordered.

Opinion of the District Court, January 6, 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

- against -

HARRY G. BURKS, JR.,
EDWARD B. BURR,
THOMAS F. CHALKER,
JOHN R. HAIRE,
HARVEY C. HOPKINS,
S. P. HUTCHINSON,
DONALD L. KEMMERER,
A. S. MIKE MONRONEY,
CHARLES F. PHILLIPS,
JEPTHA WADE,
ANCHOR CORP., and
FUNDAMENTAL INVESTORS, INC.,

Defendants.

ORDER

73 Civ. 552 (HFW)

HENRY F. WERKER, D. J.

Plaintiffs' motion for reargument based on Judge Gagliardi's decision in Boyko v. The Reserve Fund, Inc., 74 Civ. 3419 (S. D. N. Y. Sept. 31, 1975) is denied. This court finds that Boyko is distinguishable from the case at hand due to the fact that Boyko concerns Section 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b). That section specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under Section 36(a), 15 U.S.C. § 80a-35(a), where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the

statute to a security holder on such a claim.

SO ORDERED.

DATED: New York, New York

January 6, 1976

Henry F. Werker

U. S. D. J.

Opinion of the District Court, January 7, 1977

torney had represented to the court, or, if he did consent, lacked authority to do so. In effect, the Vorhauers seek to recover *against the United States* either for (1) the misrepresentations of an assistant United States Attorney, (2) the presumably unjustified reliance by an assistant United States Attorney on the authority of Mr. Scandone to consent to the destruction of plaintiffs' property, or (3) the presumably unjustified reliance by a District Judge on the representations of an assistant United States Attorney. Even if the plaintiffs were able to prove that the actions of the Assistant United States Attorney or Chief Judge Lord were in some way culpable[5] they would not be able to recover against the United States because these actions were certainly not authorized by it. See *Regional Rail Reorganization Act Cases*, supra, 419 U.S. at 127, 95 S.Ct. at 350 n. 16; *Yearsley v. Ross Construction Co.*, 309 U.S. 18, 21–22, 60 S.Ct. 413, 414–415, 84 L.Ed. 554 (1940); *Hooe v. United States*, 218 U.S. 322, 336, 31 S.Ct. 85, 89, 54 L.Ed. 1055 (1910).

[10, 11] Since this case does not fall within the rubric of the *Rail Cases*, "it follows that the asserted entitlement to money damages depends upon whether any federal statute 'can fairly be interpreted as mandating compensation by the Federal Government for the damage sustained.'" *Testan*, supra, 424 U.S. at 400, 96 S.Ct. at 954, quoting *Eastport-Steamship Corp. v. United States*, 372 F.2d 1002, 1009, 178 Ct.Cl. 599, 607 (1967). Plaintiffs have pointed to no such statute. Indeed the only arguably[6] applicable statute is the Federal Tort Claims Act, 28 U.S.C. § 2671 et seq., but it provides plaintiffs no foundation for recovery since they have failed to exhaust their administrative remedies. See 28 U.S.C. § 2675; *Bialowas v. United States*, 443 F.2d 1047, 1049 (3d Cir. 1971).

Accordingly, the complaint against the United States must also be dismissed.

Howard M. LASKER and Irving Goldberg, Plaintiffs,

v.

Harry G. BURKS, Jr., et al., Defendants.

No. 73 Civ. 552 (HFW).

United States District Court, S. D. New York.

Jan. 7, 1977.

Two stockholders of registered investment company brought stockholders' derivative action against company's investment advisor and several and present members of the company's board of directors to recover damages for purchase of 270-day notes of issuer which subsequently became bankrupt. Following denial of defendants' motion to dismiss without prejudice, 404 F.Supp. 1172, the defendants renewed their motion to dismiss. The District Court, Werker, J., held that since nondefendant minority directors sought dismissal of action, plaintiffs had burden to establish that minority directors' actions lacked independence; and that unsupported contentions of plaintiffs failed to meet burden of establishing that minority directors' actions lacked independence precluding decision to abandon derivative claims raised in suit, and thus both corporate and individual defendants could not be required to proceed to a trial.

5. It will be noted that a suit against Judge Lord individually would be barred by the doctrine of judicial immunity, see *Pierson v. Ray*, 386 U.S. 547, 87 S.Ct. 1213, 18 L.Ed.2d 288 (1967), and a suit against the assistant United States Attorney would present difficult issues of prosecutorial immunity under *Imbler v. Pachtman*, 424 U.S. 409, 96 S.Ct. 984, 47 L.Ed.2d 128 (1976).

6. The Tort Claims Act would not afford a basis for relief against the United States on account of the actions taken by Judge Lord since the Act does not cover members of the judicial branch of government. See *Cromelin v. United States*, 177 F.2d 275 (5th Cir. 1949), cert. denied, 339 U.S. 944, 70 S.Ct. 790, 94 L.Ed. 1359 (1950).

Defendants granted summary judgment.

1. **Federal Civil Procedure** ⇐2533

Since parties had each submitted affidavits and excerpts from extensive deposition testimony to assist in disposition of motion to dismiss, court was required to treat motion as one for summary judgment under rule 56. Fed.Rules Civ.Proc. rules 12(b), 56, 28 U.S.C.A.

2. **Corporations** ⇐310(1)

Fact that each of minority directors knew someone on board at time that he or she was nominated did not require preclusion of business judgment rule permitting minority of board to determine what position company should take in stockholders' derivative suit, where relationships which existed between minority directors and defendant directors were de minimis.

3. **Banks and Banking** ⇐314

Business judgment rule, permitting disinterested directors who were minority of board to determine decision to be taken in stockholders' derivative suit against, inter alia, investment advisor was not inapplicable merely because each minority director had received remuneration for service on boards of other mutual funds advised by investment advisor.

4. **Banks and Banking** ⇐314

Application of business judgment rule permitting disinterested directors who were minority of board to determine what position company should take in stockholders' derivative suit was not rendered inapplicable on theory that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisors.

5. **Securities Regulation** ⇐214

It was not inappropriate for attorney, who advised investment company, to participate in deliberations of disinterested directors, who were minority of board, prior to determination as to what position investment company should take in stockholders' derivative suit, since designating attorney as an interested person only served to limit his participation on board as a director and did not mean that minority directors were interested in suit or that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

6. **Banks and Banking** ⇐314

Presence of several defendant directors during initial presentations at meeting of disinterested quorum did not demonstrate minority directors' lack of independence thus precluding determination of position company should take in stockholders' derivative suit on behalf of investment company, since minority directors had invited such defendants to join meeting and such defendants and counsel were excused before disinterested quorum made its determination.

7. **Securities Regulation** ⇐214

Even if minority directors erred in determination made during deliberations as to what position investment company should take in stockholders' derivative suit, court could not upset their reasoned judgment without some showing that independence of disinterested quorum was impermissibly curtailed. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

8. **Securities Regulation** ⇐220

In investment company's stockholders' derivative action against company's investment advisor and several former and present members of company board of directors, since nondefendant minority directors sought dismissal of action, plaintiffs had burden to establish that minority directors' actions lacked independence. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

9. **Securities Regulation** ⇐219

In investment company's stockholders' derivative action against company's investment advisor and several former and

present members of company's board of directors, unsupported contentions of plaintiffs failed to meet burden of establishing that minority directors' actions lacked independence precluding decision to abandon derivative claims raised in suit, and thus both corporate and individual defendants could not be required to proceed to a trial. Investment Company Act of 1940, §§ 1 et seq., 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-1 et seq., 80a-2(a)(19)(A)(iv), 80a-10.

10. **Corporations** ⇐310(1)

The existence of a casual relationship among directors, without more, cannot be taken as an indication that minority directors were unable to reach an independent business decision and make determination to abandon derivative claims.

11. **Securities Regulation** ⇐214

Fact that Investment Company Act terms an attorney whose advice is sought to be an "interested person" could not suggest that minority directors had an interest in contested transaction which went beyond a generalized concern for the security of the investment company thus precluding exercise of business judgment in determination to abandon derivative claims in investment company's stockholders' derivative action. Investment Company Act of 1940, §§ 1 et seq., 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-1 et seq., 80a-2(a)(19)(A)(iv), 80a-10.

12. **Federal Civil Procedure** ⇐2470.1

Summary judgment may not be granted unless, drawing all reasonable inferences in favor of the nonmovant, no material factual issue is shown. Fed.Rules Civ.Proc. rule 56, 28 U.S.C.A.

13. **Federal Civil Procedure** ⇐2544

Party opposing summary judgment motion must adduce something beyond conclusory allegations. Fed.Rules Civ.Proc. rule 56, 28 U.S.C.A.

Aranow, Brodsky, Bohlinger, Benetar & Einhorn, New York City, by Anthony L.Tersigni, Herbert A. Einhorn, David J. Sweet, Steven Mallis, New York City, of counsel, for plaintiffs.

Seward & Kissel, New York City, for defendant Fundamental Investors, Inc.

Pollack & Kaminsky, New York City, for defendants Anchor Corp., Burr, Chalker, Haire & Hutchinson.

Dewey, Ballantine, Bushby, Palmer & Wood, New York City, for defendants Burks, Hopkins, Kemmerer, Monroney, Phillips and Wade.

OPINION

WERKER, District Judge.

This action, brought derivatively by two shareholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company, seeks to recover damages resulting from the Fund's purchase of $20 million in 270-day notes issued by the now bankrupt Penn Central Transportation Company. The defendants are Anchor Corporation ("Anchor"), the registered investment adviser to the Fund, and several past and present members of the Fund's Board of Directors ("Board"). The defendants previously moved to dismiss this suit under Rule 12(b) of the Federal Rules of Civil Procedure because a voting quorum of disinterested directors found, in the exercise of its business judgment, that maintenance of the suit would not be in the best interests of the shareholders of the Fund. In a memorandum decision on that motion, 404 F.Supp. 1172, this court held that the business judgment rule[1] applied to the actions of the

1. Under the rule,

"' . . . Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' *Politz v. Wabash R. Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of 'responsibility'

Fund and that it enabled the minority directors of the Board to seek dismissal of this suit provided only that they were "truly disinterested and independent." However, the court permitted the plaintiffs to conduct discovery for a designated period of time to determine whether the minority directors were in fact disinterested or independent, and the motion to dismiss was denied without prejudice to renew at the close of discovery. In accordance with that decision, the defendants have now renewed their motion to dismiss the instant action. The plaintiffs continue to argue that the motion should be denied because, for various reasons, the minority directors did not, and could not, exercise their independent business judgment in moving to terminate this action.

I

The facts surrounding this action have been described at length in my earlier memorandum decision; nevertheless, some repetition of that discussion will facilitate an understanding of the court's action upon the present motion by the defendants.

The complaint alleges, among other things, that Anchor breached its statutory, contractual and common law fiduciary duties by relying exclusively upon the representations of *Goldman, Sachs & Co.* (a seller of commercial paper), rather than independently investigating the quality and safety of the Penn Central 270-day notes purchased by the Fund. It is further alleged that the defendant directors knew or should have known of Anchor's failure to meet its responsibility; that they violated their common law duties as corporate fiduciaries by acquiescing in Anchor's omissions; that the financial condition of the Penn Central steadily worsened during the period from November 28, 1969 to June 21, 1970, the date that it filed for reorganization; and that during this period of decline all of the defendants failed to investigate and review the financial condition of the Penn Central and the quality and safety of its commercial paper. It is also alleged that during this period Anchor failed to recommend, and the defendant directors failed to attempt, sale of the Penn Central paper held by the Fund.

Prior to the institution of this action, the Fund and other plaintiffs brought suit against *Goldman, Sachs* seeking rescission of their purchases. *See Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974) (the "*Welch*" action). On the motion of all defendants to this action, Judge Gurfein, then a district court judge, granted a stay of further proceedings in this action pending resolution of the Fund's claims in *Welch*. Thereafter, on July 9, 1974 the Fund agreed to settle its claims against *Goldman, Sachs*. Under the terms of the settlement agreement, *Goldman, Sachs* was to take back the notes and the Fund was to receive $5,250,000 in cash and a 73.75 percent interest in any proceeds of the notes obtained during the course of the Penn Central reorganization proceeding.

With the claims of Fundamental in the *Welch* matter resolved, the Board once again faced the question of what to do in the instant action. Briefly, the Board determined that five of its members were disinterested (the "disinterested quorum" or "minority directors") and therefore able to determine the proper course of action for the Fund.[2] The disinterested quorum then retained the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the circumstances surrounding the purchase and retention of the Penn Central notes and prepare an opinion for its consideration. In a memorandum to the disinterested quorum dated December 5, 1974, Judge Fuld concluded that neither Anchor nor the defendant directors of the

is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup.Ct. 1944).

2. Under Article Eight of the Certificate of Incorporation of Fundamental, a quorum of the Board may not be less than one-third of the total number of directors. Since the full Board consisted of ten members, there was no problem here.

Fund had violated the law "in connection with the acquisition or retention of the Penn Central commercial paper." Judge Fuld's memorandum discussed several positions that the disinterested quorum could take on behalf of the Fund, one of which was concluding that the suit lacked merit and moving to dismiss. The minority directors met with Judge Fuld at a special meeting of the disinterested quorum held on December 18, 1974 and requested that he submit a further memorandum before they took any action. The minority directors also questioned several of the defendants before deciding at a second special meeting of the disinterested quorum, held on January 6, 1975, to seek dismissal of the instant action.[3] An affidavit submitted by the chairman of the disinterested quorum as part of the earlier motion to dismiss recounts ten factors that the disinterested quorum considered in arriving at its decision. The relevant portion of that affidavit appears in my earlier decision, 404 F.Supp. at 1176–77.

II

On the defendants' initial motion to dismiss, this court considered and rejected the contention of the plaintiffs that the merits of their derivative claim should color the court's consideration of the business judgment "defense." The court also reviewed the claim of the plaintiffs that the strong public policy behind the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq.*, precluded application of the business judgment rule to the actions of mutual funds. The court observed that

"absent a statutory exception whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation, including whether to prosecute a cause of action. 404 F.Supp. at 1180.

Both of these contentions have been reasserted in substantially unchanged form in the plaintiffs' papers in opposition to the renewed motion to dismiss. While a certain degree of tenacity is the mark of accomplished counsel, what the plaintiffs now seek is an opportunity to reargue the court's prior decision after the time to do so has passed. To accede to that request would require the court to reconsider arguments previously rejected without having been shown that there is a need to do so. Consequently, the court will only consider the question it did not reach before: whether the minority directors were disinterested and independent.

[1] Since the parties have each submitted affidavits and excerpts from the extensive deposition testimony to assist in the disposition of the instant motion, the court must treat the motion as one for summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Rule 12(b), Fed. R.Civ.P.

III

The plaintiffs first contend that the structure of the mutual fund industry, which subjects mutual funds to extensive control by their investment advisers, precludes a finding of independence in this instance.[4] Specifically, they maintain that the large number of shareholders in the Fund coupled with the small size of each

3. As was noted in my earlier decision in this matter, although one of the five minority directors voted by proxy, even without her vote, the presence of four directors at the meeting constituted a quorum.

4. In this regard, plaintiffs note Chief Judge Kaufman's recent statement that:

"The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand v. Chestnutt Corp.*, Civ. No. 76–7156 (S.D. N.Y. Nov. 4, 1976).

shareholder's interest, makes proxy contests impossible to wage and ensures that the Board will only contain directors amenable to the policies of the Fund's management.[5] The plaintiffs also suggest that the service of each minority director for compensation on the boards of other "Anchor" funds demonstrates their inability to act independently. In this vein, the plaintiffs maintain that business and personal relationships among the defendants and minority directors make it impossible to conclude that the disinterested quorum acted independently; that even if the minority directors acted in good faith, their loyalties must have been divided.

[2] Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently. Although each of the minority directors knew someone on the Board at the time that he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis*, even as they are stated by the plaintiffs, and do not suggest that the business judgment rule should not be applied.

[3] There is also no reason to conclude that the business judgment rule is inapplicable merely because each minority director receives remuneration for service on the boards of other "Anchor" funds. Most corporate directors receive some compensation for their services, but absent a showing of improper motive they have always been permitted to apply their business judgment to decisions involving derivative suits brought against the corporations they serve. *See, e. g., Warshaw v. Calhoun*, 43 Del.Ch. 148, 221 A.2d 487 (Sup.Ct.1966). I am not persuaded that there is any meaningful distinction between remuneration by one corporation rather than several corporations similar in structure. This is not, after all, an instance where it is alleged that a minority director received payments from the investment adviser or other persons whose interests conflict with those of the Fund.

[4] The plaintiffs' contention that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisers parallels, to some extent, their previously rejected argument that the business judgment rule should not apply to mutual funds registered under the Investment Company Act of 1940. In making this claim, plaintiffs apparently rely upon *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), but that decision is inapposite. In the *Fogel* case, two mutual fund stockholders brought a derivative suit on behalf of a mutual fund against several affiliated fund directors and the advisor to the fund. The plaintiffs sought to recapture a portion of the brokerage commissions paid on fund transactions on the theory that the affiliated directors had "intentionally misled and misinformed the [f]und's unaffiliated directors by telling them that such recapture was not available to the [f]und." *Id.* at 737.

Writing for the *Fogel* panel, Judge Friendly observed that:

> "Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the [f]und's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by

5. At about the time that the minority directors determined to seek the dismissal of this action, there were approximately 141,000 shareholders in the Fund. No shareholder had a beneficial interest greater than one percent.

> disinterested counsel furnished to the independent directors."

Id. at 749–50.

Significantly, Judge Friendly went on to observe that:

> "If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the [f]und should make no effort at recapture, we would have a different case."

Id. at 750.

In the instant action, the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them. Clearly, then, under *Fogel* it was proper for them to determine what the Fund's posture would be.

IV

The plaintiffs next contend that the lack of true independence and disinterestedness on the part of the minority directors is apparent from the manner in which they decided to seek dismissal in the instant action. In support of this claim, plaintiffs point to the actions of Roger T. Wickers, an Anchor vice-president who formerly served as the secretary to the Fund, and Eugene P. Souther, who was retained as special counsel to the Fund for the purposes of this litigation, as well as to the circumstances surrounding the meetings of the minority directors.

At the direction of defendant Haire, Wickers explored the possibility of retaining special counsel for the disinterested quorum. After contacting several distinguished attorneys, Wickers reported that Judge Fuld would be available to serve the minority directors and, at a Board meeting held on July 24, 1974, it was Wickers who proposed that a disinterested quorum act for the Fund in the instant action. Wickers also coordinated the arrangements for Judge Fuld's investigation for the minority directors, who were residents of several different states.

The plaintiffs maintain that "the inappropriateness of Wickers role as intermediary is manifest," but I disagree. The plaintiffs have not set forth any facts in support of their suggestion that Wickers improperly influenced the deliberations of the disinterested quorum. Instead they have engaged in totally unsubstantiated supposition. For example, plaintiffs contend that Wickers retained Judge Fuld, but the sworn affidavit of Wickers and the deposition of a least one minority director establish that Judge Fuld was retained by the minority directors to act upon instructions communicated to him at the direction of the disinterested quorum.[6] In the absence of some factual support for the plaintiffs' allegations, the court cannot conclude that it was improper for Wickers to coordinate the administrative details of Judge Fuld's inquiry or that Wickers' actions reduced the independence of the minority directors.

[5] It is the court's opinion that the role of Souther was equally innocent. The plaintiffs advance two reasons why it was inappropriate for him to participate as he did in the deliberations of the disinterested quorum. First, they note that he was an "interested person" within the meaning of § 2 of the Investment Company Act, 15 U.S.C. § 80a–2(a)(19)(A)(iv)[7] because his

6. Even if Wickers did retain Judge Fuld for the minority directors, I see nothing improper in that. In fact, in *Fogel, supra*, Judge Friendly suggested that it was desirable for disinterested counsel to be "*furnished*" to the independent directors.

7. Under the statute:

> "(19) 'Interested person' of another person means—
>
> (A) when used with respect to an investment company—
>
> * * * * * *
>
> (iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company . . . "

law firm had acted as legal counsel to the Fund during the last two fiscal years. They question whether the minority directors could arrive at a disinterested decision when they were advised by an attorney who was "interested." Second, the plaintiffs contend that it was improper for his firm to counsel parties with divergent interests, namely the Fund and the disinterested quorum.

All attorneys providing legal counsel to mutual funds become, by definition, "interested persons" for some period of time. Under § 10 of the Investment Company Act, 15 U.S.C. § 80a–10, only 60 percent of the members of the board of a registered company may be interested persons. Designating Souther as an interested person, therefore, only serves to limit his participation on the Board *as a director*. It does not mean that the minority directors were interested in the suit, that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence.

Plaintiffs nevertheless suggest that in accordance with Judge Frankel's recent decision in *Papilsky v. Berndt*, CCH Fed.Sec.L. Rep. ¶ 95,027 (S.D.N.Y.1976), it was improper for Souther to advise both the Fund and the minority directors. However, in *Papilsky* the law firm advising the fund also served as the investment adviser's counsel, and, as Judge Frankel noted, there was no "suggestion to the Board that, because of the possible conflict of interest, the independent directors should seek disinterested counsel." *Id.* at 90, 133. In the instant action, independent legal advice for the minority directors was not only recommended, it was also obtained. Moreover, there was no conflict of interest on the part of Souther or his law firm: they were retained to represent the Fund in the instant action and it was the disinterested quorum, acting for the Fund, which gave them their instructions as to how to proceed.

[6] The plaintiffs also contend that the presence of several defendants during the initial presentations of Judge Fuld and Souther at the first special meeting of the disinterested quorum demonstrates the minority directors' lack of independence. But the minutes of that meeting and the deposition testimony show that the minority directors invited those defendants to join the meeting so that they could answer questions raised by the minority directors. The minutes of the meeting also indicate that all of the defendants and counsel were excused before the disinterested quorum determined in executive session that it wished to review the pertinent documents and formulate further questions to be answered before reaching any decision.

In this context plaintiffs point to the allegedly misleading nature of statements made to the minority directors by defendant Haire. The minutes of the first special meeting of the disinterested quorum state that Haire "questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if [the instant action] were being pursued with the acquiescence, if not under the control, of the Fund." The plaintiffs consider this to be in sharp disagreement with Haire's testimony at his disposition that he "never at any time had any doubt that [Anchor] could continue to effectively serve the [F]und if . . . requested to continue or permitted to continue by the board or the shareholders." Apparently to underscore the materiality of Haire's discouraging words to the minority directors, plaintiffs note the contents of an affidavit by the chairman of the disinterested quorum. In that affidavit, the quorum chairman states that in reaching their decision the directors considered that:

> "(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment advisor and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders . . . ."

[7] The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only the the minority directors reached a different conclusion: that prosecution of the suit "would necessarily cause the Fund to seek to obtain a different investment adviser immediately." Even if the minority directors erred in this determination, as I have noted in my previous decision, the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence.

V

Finally, the plaintiffs contend that under *Perlman v. Feldman*, 219 F.2d 173, 178 (2d Cir.), *cert. denied*, 349 U.S. 952, 75 S.Ct. 880, 99 L.Ed. 1277 (1955), and *Pepper v. Litton*, 308 U.S. 295, 306, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the defendant directors bear the burden of proving by clear and convincing evidence that they did not breach their fiduciary responsibilities to the corporation and its stockholders. The defendants argue that the plaintiff must shoulder the evidentiary burden because it is the exercise of business judgment by corporate directors which is challenged. *Bellis v. Thal*, 373 F.Supp. 120, 124 (E.D.Pa.1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975); *Marco v. Bank of New York*, 272 F.Supp. 636, 639 (S.D.N.Y. 1967), *aff'd*, 398 F.2d 628 (2d Cir. 1968); *Warshaw v. Calhoun, supra.*

The *Perlman* and *Pepper* cases relied upon by the plaintiffs both involve self-dealing by corporate fiduciaries and are inapplicable here. As I noted in my earlier decision in this matter, the plaintiffs "have not argued that the minority directors have acted fraudulently or corruptly." 404 F.Supp. at 1180. Moreover, the question before the court is not whether *the defendants* breached their fiduciary obligations to the corporation, but whether suit can proceed against them at all given the decision of the nondefendant minority directors to seek dismissal of this action.

[8, 9] It is therefore incumbent upon the plaintiffs to establish that the minority directors actions lacked independence. *Marco v. Bank of New York, supra.* The unsupported contentions of the plaintiffs clearly fail to meet this burden and, accordingly, it is the opinion of this court that the defendants, both corporate and individual, cannot be required to proceed to a trial. I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit.

[10, 11] To conclude that the disinterested quorum acted in response to pressure and without justification to immunize Anchor and the defendant directors from possible liability would require this court to presume that bias exists based upon circumstances which seem entirely innocent. For example, as has been noted, the plaintiffs suggest that a finding of improper influence must follow from the fact that the minority directors each knew someone on the Board when they were first selected for nomination or election to the Board. But the existence of casual relationships among

the directors, without more, cannot be taken as an indication that the minority directors were unable to reach an independent business decision. Similarly, because the Investment Company Act terms an attorney whose advice is sought to be an "interested person," plaintiffs seek to suggest that the minority directors had an interest in the contested transaction which went beyond a generalized concern for the security of the Fund.[8] But here again it was obviously reasonable for the minority directors to consult with interested persons, rather than reaching a decision without speaking to either the directors involved in the transaction or counsel.

[12, 13] The court of appeals for this circuit has recently cautioned that summary judgment may not be granted unless, drawing all *reasonable* inferences in favor of the nonmovant, no material factual issue is shown. *Heyman v. Commerce and Industry Insurance Co.*, 524 F.2d 1317 (2d Cir. 1975). However, the party opposing the motion must adduce something beyond conclusory allegations. *Donnelly v. Guion*, 467 F.2d 290 (2d Cir. 1972). Here, there has been no showing by the plaintiffs of facts which, if proven, would prohibit the defendants from hiding behind the business judgment cloak. Accordingly, the defendants are granted summary judgment.

SO ORDERED.

Joseph THOMPSON et al.

v.

Victor YUE.

Civ. A. No. 76-1126.

United States District Court,
D. New Jersey.

Jan. 10, 1977.

Personal injury action was brought in Federal District Court, sitting in New Jersey, as result of automobile accident in Quebec, Canada, involving Illinois plaintiffs and a New Jersey defendant. On defendant's motion for summary judgment on grounds that suit was time barred by Quebec's one-year personal injury statute of limitations, the District Court, Barlow, J., held that New Jersey's conflicts of law principles were binding on the court; and that, on the basis of its factual contacts with the case, New Jersey's substantive law would be applied, including its two-year limitation period.

Defendant's motion for summary judgment denied.

1. Federal Courts ⚩409

Federal court sitting in diversity is bound to apply choice of law rules of forum state.

2. Federal Courts ⚩409

In personal injury action initiated in federal court sitting in New Jersey, arising from automobile accident which occurred in Quebec, Canada, involving Illinois plaintiffs and New Jersey defendant, New Jersey's conflicts of law principles were applicable and binding on court.

3. Limitation of Actions ⚩2(1)

Where suit is brought on foreign cause of action in New Jersey court, court will not employ state's statute of limitations but

8. In a similar effort to brand a minority director as interested, plaintiffs point to the following testimony by director Stephens:

> "I remember commenting [at the July 24, 1974 board meeting] on what constituted a disinterested director because in my opinion no director could be disinterested, but I was told that was the proper term.

Later Stephens explained that he didn't like the term "disinterested" since he certainly was not "uninterested."

Opinion of the Court of Appeals, January 11, 1978

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 23—September Term, 1977.

(Argued August 31, 1977 Decided January 11, 1978.)

Docket No. 77-7060

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

—v.—

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

Before:

LUMBARD, OAKES and MESKILL,

Circuit Judges.

Appeal from dismissal in the Southern District, Werker, *J.*, of stockholder derivative suit against directors of mutual fund and fund's investment adviser.

Reversed.

ANTHONY L. TERSIGNI, New York, N.Y. (Aranow Brodsky Bohlinger Benetar & Einhorn, Steven Mallis, Herbert A. Einhorn, David

J. Sweet and Richard N. Gray, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

DANIEL A. POLLACK, New York, N.Y., *for Defendants-Appellees.*

SEWARD & KISSEL, EUGENE P. SOUTHER and ANTHONY R. MANSFIELD, New York, N.Y., on the brief, *for Defendant-Appellee Fundamental Investors, Inc.*

POLLACK & KAMINSKY and MARTIN I. KAMINSKY, New York, N.Y., on the brief, *for Defendants-Appellees Anchor Corporation, Edward B. Burr, Thomas F. Chalker, John R. Haire and S. P. Hutchison.*

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD, LEONARD JOSEPH, JOHN M. FRIEDMAN, JR., New York, N.Y., on the brief, *for Defendants-Appellees Harry G. Burks, Jr., Harvey C. Hopkins, Donald L. Kemmerer, A. S. Mike Monroney, Charles L. Phillips and Jeptha H. Wade.*

LUMBARD, *Circuit Judge:*

This appeal by two mutual fund shareholders raises an important question of first impression: Can minority directors of a registered mutual fund, who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act, 15 U.S.C. §80a-10(a), terminate a nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser? We are of the view that to permit such action by those "independent"

minority directors of a registered mutual fund would be contrary to the public interests which Congress has sought to protect. Accordingly, we reverse the judgment of the district court which dismissed the complaint and remand for further proceedings.

Howard Lasker and Irving Goldberg commenced this derivative action in February, 1973, against individuals who had been directors of Fundamental Investors. Inc. (the Fund), an open-end investment company[1] registered under the Investment Company Act, 15 U.S.C. §80a-1 to -52, and the Fund's registered investment adviser, Anchor Corporation. The plaintiffs sought to recover losses sustained by the Fund in connection with its purchase between November 28 and December 8, 1969, of $20 million in Penn Central 270-day notes from Goldman, Sachs & Co. The derivative complaint charged the defendants with violations of §§13(a)(3) and 36 of the Investment Company Act. 15 U.S.C. §§80a-13(a)(3), 80a-35 (1970), breach of their common-law fiduciary duties, violations of §206 of the Investment Advisers Act, 15 U.S.C. §80b-6 (1970), and breach of Anchor's investment advisory contract with the Fund.

It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. On June 21, 1970, Penn Central filed a petition for reorganization which is still in process in the Eastern

1 An open-end investment company is defined in §5(a)(1) of the Investment Company Act, 15 U.S.C. §80a-5(a)(1) (1970), as an investment company that offers "for sale or has outstanding any redeemable securities of which it is the issuer." "Investment company" is defined in §3(a) of the Act, 15 U.S.C. §80a-3(a) (1970).

District of Pennsylvania. Consequently, the Fund's Penn Central notes were not paid at maturity.

In November 1970, the Fund, joined by three other noteholders,[2] sued Goldman, Sachs in the Southern District of New York for recovery of their losses arising from their purchases of Penn Central notes. In July 1973, then District Judge Gurfein stayed the instant action, which had been commenced five months earlier, pending resolution of the suit against Goldman, Sachs. That suit was settled on behalf of the Fund in July 1974. Under the settlement, Goldman, Sachs took back the Fund's Penn Central notes, paid the Fund $5,250,000, and assigned to the Fund a 73.75 per cent interest in the proceeds of the notes in the reorganization proceedings. The Fund's co-plaintiffs did not settle, and the jury rendered verdicts in their favor against Goldman, Sachs for the full amount of their claims.[3]

On July 24, 1974, the Fund's board of directors met and discussed the pending *Lasker* case. They decided that five of the statutorily disinterested directors, none of whom were involved in the derivative action,[4] should decide what action should be taken regarding the *Lasker* case, and act accordingly on behalf of the entire board.[5] This procedure

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2 In addition to the Fund, Welch Foods, Inc., C.R. Anthony Company, and Younker Brothers, Inc. sued Goldman, Sachs in a single action. See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974).

3 See *Welch Foods Inc. v. Goldman, Sachs & Co.*, No. 70 Civ. 4811 (jury verdict S.D.N.Y. 1974).

4 Of the remaining six directors of the eleven member board, all were defendants to the *Lasker* action and/or affiliated with Anchor.

5 Under the Fund's bylaws and Delaware corporate law, five of the Fund's twelve member board of directors constituted a quorum of the entire board. Del. Code tit. 8, §141 (1975); Fundamental Investors, Inc., Certificate of Incorporation, Article EIGHTH; Fundamental Investors, Inc., Bylaws section 4, Article VI.

The five directors appointed to review the *Lasker* action were: Leon Kendall, elected to the board in June 1974; Beryl Robichaud, elected

had been discussed prior to the July board meeting by the defendant John R. Haire, president of the Fund and chairman of Anchor's board of directors, and Roger Wickers, an officer of both the Fund and Anchor. Upon Haire's instruction, Wickers had ascertained that Stanley H. Fuld, former chief judge of the New York Court of Appeals, would be available to serve as special counsel. The minority directors agreed to consider what should be done about the *Lasker* case, and instructed Wickers to retain Judge Fuld to advise them.

Judge Fuld, in his report of December 5, 1974, supplemented on December 18, 1974, concluded, on the basis of the information furnished to him, that neither Anchor nor the Fund directors would be found liable under federal or state law. At the same time, Judge Fuld pointed out the absence of legal authority on whether a mutual fund's investment adviser is required to conduct independent research regarding its investment recommendations. He further cautioned that it was "impossible to predict . . . what a trier of fact will find, particularly in complex circumstances." After considering the special counsel's reports, on January 6, 1975, the minority directors instructed counsel for the Fund to seek dismissal of the *Lasker* action on the ground that it was their business judgment that further prosecution of the action would not be in the best interests of the Fund.

Judge Werker, in passing on the motion to dismiss, held that the minority directors, in the exercise of their business judgment, had the power to bar further prosecution of the case, provided they were truly disinterested and independent. As a factual issue had been raised regarding whether the minority directors were independent and disinterested,

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in September 1973; William Stephens, elected in September, 1973; Mary O'Connor, elected in June 1972; and Louis Laun, who became a director in the fall of 1971.

he granted discovery on that issue. *Lasker* v. *Burks,* 404 F.Supp. 1172 (S.D.N.Y. 1975). After such discovery, the motion to dismiss was renewed and granted by Judge Werker on January 7, 1977. In his second opinion, 426 F.Supp. 844 (S.D.N.Y. 1977), Judge Werker found no factual support for the conclusion that the minority directors had not acted independently. In accordance with his earlier opinion, he dismissed the complaint.

From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

In response to disclosure of grave abuses in the management of investment companies, Congress in 1940 enacted the Investment Company Act (ICA), 15 U.S.C. §§80a-1 to -52 (1970), and the Investment Advisers Act (IAA). 15 U.S.C. §§80b-1 to -21 (1970). Congress acted after receiving a report from the Securities and Exchange Commission which showed that investment funds were organized by investment advisers; that the funds were administered under

contracts that were highly favorable to the advisers; that the directors of the funds were selected by the investment adviser; and that the board was usually dominated by persons affiliated with the adviser.[6] Congress found that numerous practices in the management of such funds adversely affected the national public interest and the interest of investors. Accordingly, Congress declared it to be the policy and purpose of the ICA to mitigate and eliminate those aspects of the conduct and administration of the funds which benefited the managers and adversely affected the stockholders of the fund.[7]

The ICA provides that no more than 60% of a registered company's board of directors can be "interested persons" affiliated with the investment adviser.[8] Moreover, it gives the statutorily disinterested directors, usually referred to as "independent directors," certain powers to supervise management and auditing arrangements.[9] Thus, section 15(c) of the ICA, 15 U.S.C. §80a-15(c) (1970), imposes on the disinterested directors the duty to review and approve the contracts of the investment adviser and the principal underwriter; section 16(b), 15 U.S.C. §80a-16(b) (1970), provides that the statutorily disinterested directors will appoint other disinterested directors to fill vacancies resulting from the assignment of the advisory contracts; and section 32(a), 15 U.S.C. §80a-31(a) (1970), requires that the accountants who prepare the investment company's Securities and Exchange Commission financial fil-

6 See SEC, Report on the Study of Investment Trusts and Investment Companies, pt. 3, 1-49, 1922 (1940). See also Comment, Duties of the Independent Directors in Open-End Mutual Funds, 70 Mich.L.Rev. 696, 701 (1972).

7 15 U.S.C. §80a-1 (1970).

8 See 15 U.S.C. §§80a-10, 80a-2(a)(3), (19) (1970).

9 See generally Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich.L.Rev. 696 (1972).

ings be selected by the statutorily disinterested directors. We conclude, therefore, that the statutes were designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Congress has not been satisfied, moreover, that the presence of disinterested directors who observe their duties will be sufficient protection to the stockholders, as it has specifically provided in section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser and the principal underwriter. See 15 U.S.C. §80a-35(b) (1970). Section 36(b) was enacted as a part of the 1970 amendments, which resulted in part from the Senate report which indicates that the mere presence of disinterested directors on the boards of mutual funds was not sufficient to protect funds against overreaching investment advisers.[10]

We have been sensitive to the need for protection of the public interest in accordance with the views of Congress. Thus, in *Galfand* v. *Chestnutt*, 545 F.2d 807 (2d Cir. 1976), we found that the investment adviser had abused its position of trust by securing a favorable modification of its advisory contract without fully disclosing to the fund's directors the ramifications of the changes. Writing for the panel, Chief Judge Kaufman observed that, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which

10 See 1970 U.S. Code Cong. & Admin. News, 4897, 4901. In 1970 both the ICA and the IAA were substantially amended. See Act of December 14, 1970, Pub.L.No. 91-547, 84 Stat. 1413.

selects its portfolio and administers its daily business." Id. at 808. See also *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977).

Moreover, in many instances where no specific authority is granted by statute the courts have inferred that stockholders may bring suit. See, e.g., *Abrahamson* v. *Fleschner*, No. 75-7203, slip op. at 6227-29 (2d Cir. Feb. 25, 1977) and cases cited therein. It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

In the ordinary routine business of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors.[11] The continued service of the "statutorily" disinterested directors, for which in this case they were paid from $11,000 to $13,000 *per annum*,[12] depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for

11 See Comment, supra note 9, at 702.

12 In addition to their role as directors of the Fund, each of the five minority directors served on the boards of five other Anchor affiliated funds, and all but one of the directors sat on a sixth Anchor related board.

the individuals concerned.[13] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuance of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties. Of course here we do not reach the question of whether a court should defer to the decision of statutorily disinterested directors of an investment company to terminate a shareholder derivative suit which the court finds to be frivolous.

Our conclusion makes it unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent to determine that the litigation be ended.[14] We have no doubt that the five minority directors acted in good faith in all that they did.

Reversed and remanded for further proceedings.

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13 See *Fogel v. Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975); Nutt, A Study of Mutual Fund Independent Directors, 120 U.Pa.L.Rev. 179, 216 (1971).

14 Similarly, the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations. Moreover, none of these cases involves the situation here, where the terminating directors owe their position as directors to the defendants in the suit.